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Central Intelligence Agency



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Contribution to Interagency Study on US-China Economic Relations

Summary

Since the Third Plenum of the 11th Central Committee in December 1978, China has been engaged in a process of economic readjustment and reform that continues today. Beijing has turned away from a philosophy of isolated self-reliance to one of expanding international involvement. In the closing months of 1984, Beijing continues to promulgate new policies that will, if effectively implemented, give China a more open economy, with greater flexibility and responsiveness to market forces. [redacted]

The October Plenum

On 20 October 1984, the Third Plenum of the 12th Central Committee gave China's economic reform program a sweeping endorsement. According to the Plenum's "Decision on Reform of the Economic Structure" and reports from other authoritative sources, China plans to allow production and pricing of many commodities according to supply and demand, with a limited number

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of goods under loose "guidance" plans and a few key products strictly controlled.¹ Beijing also will release control of distribution of those goods not controlled by the state, so that producers will be responsible for arranging both marketing and transport of their goods. This also allows private transport of agricultural goods, which may help alleviate regional shortages and surpluses that have characterized China's food distribution system. Beijing also intends to make wider use of such economic levers as taxes and interest rates to force enterprises toward greater efficiency and profitability, although windfall profits will be discouraged by an "adjustment" tax. The mechanisms by which price and other financial reforms will be introduced have not yet been explained.

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Beijing is clearly sensitive to charges in the foreign press that China is "going capitalist." The announcements of these reforms have been carefully crafted to embed structural changes within the context of socialism. The Central Committee Decision, for example, stressed that China's productive forces are still owned by the people and are therefore socialist, the only difference from the past being that it is now "commodity socialism." This is permissible, says the Decision, because the state cannot collect, absorb, and act on the necessary information fast enough to run the economy efficiently. It is also notable that most of these reforms have been evolving for several years--experiments in selected areas and in agriculture began in the late 1970s. Perhaps the greatest significance of the October party conclave is its endorsement--long sought by the reformist leadership--of a comprehensive package of economic reforms. Endorsement does not equate to policy implementation, however, and the task of making the party's proposals work promises to be a difficult one.

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Agriculture--The Centerpiece of China's Economic Reforms

Reform of China's agricultural production and marketing systems began in 1978 and initially focused on increasing production. The reforms were not a wholesale abandonment of central government control over China's rural areas. Rather, they were a combination of (1) better central planning, (2) a cutback in the extent of government intervention in and control of routine decisionmaking, and (3) improved producer incentives. The main elements of the program involved:

Prices--Government procurement prices for farm products were increased substantially with a round of major price increases in

¹ Among goods that will continue to be State-controlled are coal, crude oil, electricity, steel, nonferrous metals, timber, cement, selected machinery, grain, cotton, pigs, oilseeds, synthetic fibers, newsprint, cigarettes, and tobacco.

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1979 followed by smaller increases for selected crops in later years. Because of these changes, the average price paid by the government for farm produce has escalated steadily, rising by nearly 48 percent between 1978 and 1983. [REDACTED]

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Contracting with households--The largest share of production activity was turned over by production teams to individual households. Prior to 1978 income was only weakly tied to individual effort because of the egalitarian distribution practices of production teams. Under the household contract system now in place, farmers can see a direct link between their efforts and the income they earn. This has led to greater work effort as well as to better farm management. [REDACTED]

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Reopening free markets--Initial steps to reform the marketing system opened up new distribution channels for additional production by farm families. Between 1978 and 1983 the government expanded free market trade. These efforts were limited--free market sales were only a small share of total retail sales in 1983--but they nonetheless made an important contribution to increasing incentives and broadening the scope of farm production. [REDACTED]

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Specialization--Restoration and expansion of regional specialization were also an important element of policies introduced between 1978 and 1983. Steps to promote specialization included encouraging the formation of specialized households to concentrate on the production of a single crop or product. These specialized households now account for at least 10 percent of all rural households. While some of the increase in specialization is the result of greater freedom of choice for farmers, an important part is because of better government planning. The government has readjusted production and procurement targets between regions and guaranteed food supplies for regions and households that are specializing in production of non-food items. [REDACTED]

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Production Up Sharply

China's recent agricultural performance has given the government the peg needed to justify its swing away from orthodox Marxist economic practices. Between 1978 and 1983, the value of farm output rose by 46 percent and per capita rural incomes jumped by 121 percent after stagnating for more than two decades. The total value of agricultural output jumped 9 percent in 1983, more than double the 4-percent goal set in the annual plan. Grain production--the key indicator--hit a record 387 million tons, and will likely exceed 400 million tons this year. China credits its experiment with market-oriented practices for the recent agricultural gains, although better-than-average weather conditions and price adjustments also played important roles. [REDACTED]

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Beijing is also touting the reforms for their impact on rural employment. In pursuit of profits, an increasing number of peasants have put down their plows to engage in either commercial activities in the service sectors--opening restaurants, repairing shoes and clothing, cutting hair, etc.--or production of handicraft items. Given the traditional labor surplus in agricultural production, the government has welcomed the shift. Beijing hopes by the end of the century to have about 40 percent of its rural labor force employed in nonagricultural production. [REDACTED]

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Industrial Performance--A Different Story

Output Up, Efficiency Down, Problems Mounting

China's industrial performance, when measured in terms of total output, also appeared more than satisfactory. The total value of industrial output rose a sharp 10 percent last year, well ahead of the planned 4-percent growth rate. But the overall output figures belie the fact that, to date, industrial reform has failed to meet its primary goal of increasing efficiency. Neither the productivity of labor nor the efficiency with which capital is used have been raised significantly. [REDACTED]

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Indeed, both the pace and the direction of industrial growth in recent years have been dictated more by the readjustment policies of 1979 than by industrial reform. Like the bulk of economic programs instituted prior to 1980, readjustment attempted to change the composition of national income without altering the underlying system of direct central government control. Whereas high rates of investment--especially in heavy industry--were favored during most of the previous decade, under readjustment Beijing attempted to scale back the rate of investment in favor of consumption. The composition of investment was also altered to benefit light industry. [REDACTED]

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The sharp improvement in urban consumer welfare that is now apparent in China is also largely attributable to readjustment, not reform. Although the bonus system that was introduced under the reforms put more cash in the hands of consumers, it was the readjustment's emphasis on light industry that began actually making consumer goods available. [REDACTED]

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The energy sector provided Chinese policymakers with what was perhaps the most pleasant surprise of 1983. Primary energy output rose 6.7 percent, the fastest pace in five years. When energy saving measures are included, the gain exceeds 9 percent. A new incentive system which allowed producers to market above-quota production at higher prices had a major impact on the production of coal--China's largest energy source--and probably boosted oil output as well. A newly instituted tax on energy consumption probably contributed to energy savings. [REDACTED]

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Performance in the transportation sector has been satisfactory, given the meager investment that Beijing has devoted to it over the past few years. The 7.6-percent increase in goods transported last year came mainly from improved management of existing facilities. [REDACTED]

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The Other Side of Reform--Mounting Problems

Progress in furthering reform has been slow--in part due to a host of problems that emerged or were exacerbated by the new policies. In many cases, the problems were reflections of ideological confrontations between advocates of the rigid Maoist policies practiced in China during 1965-76, and those favoring the more market-oriented approach introduced by Deng Xiaoping and his colleagues since 1978. [REDACTED]

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But economic reforms also were threatened by a series of real financial problems that accompanied decentralization of economic decisionmaking. The fiscally conservative government has had to reconcile itself to 5 consecutive budget deficits totalling about 55 billion yuan. Treasury bonds have been used to help finance the deficit without totally resorting to the inflationary printing of money; however, Beijing is growing increasingly concerned about its ability to balance revenues and expenditures. [REDACTED]

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On the revenue side, budget shortfalls stemmed in part from the decision to hold the line on production of heavy industrial goods--the major revenue generator. When heavy industrial output levelled-off in 1980 and then declined in 1981, revenues suffered. Beijing's efforts to spark productivity by allowing enterprises to retain a significant portion of their profits also reduced revenues. [REDACTED]

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Even successful agricultural reforms compounded financial problems on the expenditure side. Procurement prices for agricultural products were increased sharply beginning in 1979 to boost rural incomes, while consumer prices for those products went relatively unchanged. The result of these and other pricing problems was a huge gap requiring more than \$70 billion in price subsidies between 1979 and 1983. Price subsidies alone took nearly one-fourth of total state revenue in 1983. [REDACTED]

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The devolution of decisionmaking authority to lower levels also threatened to untrack China's high-priority infrastructure investment program. Enterprise managers, using their new authority to make capital investment decisions, ignored government pleas to hold the line on industrial investment; between 1979 and 1982, extrabudgetary investment in capital construction more than doubled. The increase not only drained funds needed to carry out the infrastructure investment program, it also left China short of cement, glass, and other construction supplies needed to upgrade existing facilities and infrastructure. Furthermore, when operational, many of the

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projects absorbed raw materials needed by larger, more efficient state-run enterprises. [REDACTED]

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Pushing Ahead With Reform--The 1984 Policy Shift

Unwilling to accept continued stagnation, the leadership decided to press ahead with its new policies. In January, Beijing issued Central Document No. 1, a comprehensive summary of all the rural reform measures, for study by provincial and local leadership. In April, the State Council issued new regulations lifting--at least for selected enterprises--a cap imposed only a year earlier on bonuses. New regulations also permitted factories and commercial enterprises to experiment with new wage programs. In May, the "Provisional Regulations on Greater Freedom for State-Owned Industrial Enterprises" were published, permitting enterprises to:

- Produce whatever goods are in short supply after fulfilling state plans for their normal output.
- Set retail prices for industrial machinery and other means of production within a range of 20 percent around the state price.
- Decide what share of their income will go to production, expansion, reserves, and bonuses.
- Lease or rent equipment as long as proceeds go to upgrade existing facilities.
- Recruit technical specialists directly and develop pay standards.

Although many of these measures were little more than restatements of policies Beijing had experimented with during the previous three years, they signaled a renewed commitment to industrial reform. [REDACTED]

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Zhao's government work report at the May session of the National People's Congress gave official confirmation to the policy shift. In addition to reviewing and praising various foreign and domestic policies, Zhao spoke forcefully and at great length on the "urgent" need for urban reform. Specifically, Zhao called for:

- Implementation of the second stage of China's tax reform program to give enterprises even greater financial autonomy.
- Experimental restructuring of the managerial system in the construction industry, replacing financial appropriations with bank loans, using public bidding procedures to issue contracts, and revamping the material distribution system to alleviate shortages.

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- Better utilization of educated technicians in planning and management of the industrialization process.
- Reform of the commodity circulation system to facilitate the flow of goods between town and country, and the exchange of goods between different regions.

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By late June, the China Daily was printing articles advocating such market-oriented practices as forcing state banks to compete against each other for deposits and loan business and allowing domestic enterprises to issue stocks, bonds, and other securities. A Shanghai official at about the same time argued that China should expand its financial markets to allow secondary trading of enterprise-issued notes.

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Perhaps most notable was the emergence of a host of articles advocating an early resolution of the price question. Prior to this time--despite the view widely held by Western and Chinese economists alike that the entire experiment with market tools could not succeed within the framework of China's irrational prices--only the most vocal advocates of economic reform had suggested moving quickly to tackle the potentially explosive issue of price reform. Ultimately, price reform became one of the key features of the October Plenum decision discussed above.

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Trade and Investment Ties

In the international arena, too, China's policies have evolved from isolation to involvement. China's door, still locked tight as recently as nine years ago, has swung wide open in recent years, as thousands of Chinese students have continued their studies abroad and foreign investors and technicians have been welcomed to China. Beijing now has formal links with such international economic institutions as the World Bank, IMF, and the Multi Fiber Arrangement and is moving toward membership in the Asian Development Bank and GATT.

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Foreign Investment

Beijing's past progress in attracting foreign investment has been slow, in part, because of an uncertain commitment among Chinese leaders and planners on the extent of incentives that should be offered to foreign companies. Other obstacles to success included China's inexperience; its need to develop credibility in relationships with foreign businessmen; its lack of adequate infrastructure; problems with labor productivity and wages; and the lack of detailed regulations on taxes and remittances of profits.

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Now China is becoming more active in the world economic scene, expanding its trade and investment linkages and participating more in international economic organizations. Its higher profile has attracted the interest of foreign firms and forced, albeit very slowly, Chinese accommodations to standard international business practices. We believe a prime area of potential trade growth over the next decade will be that evolving from direct ties between foreign and Chinese firms, such as joint ventures, co-production, and cooperative project development. These arrangements generate both imports--technology, materials, and equipment--and exports. Much of recent sustained export expansion can indeed be traced to ties with foreign firms, particularly compensation trade links established in the late 1970s. For example, Chinese pharmaceutical exports have grown from \$4.7 million in 1979, when several pharmaceutical ventures were established, to \$25 million in 1983, an average annual increase of more than 50 percent. []

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Over the past five years the Chinese have undertaken several steps to increase foreign participation in their economy through trade and investment:

- Opened 19 coastal sites (14 just this year) to foreign investment, offering more liberal business terms than offered elsewhere in China.
- Passed laws governing taxation, liability, patent protection, trademarks and investment procedures for foreign firms.
- Expanded the array of products of joint Chinese-foreign firms that may be marketed within China.
- Held many investment conferences to publicize hundreds of projects for which the Chinese want Western technology, equipment, capital, management, and marketing.
- Negotiated tax, investment, and other cooperation accords with several countries to clarify such issues as expropriation policy, arbitration procedures, repatriation of profits, and labor compensation. []

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By the end of 1983 there were 188 "equity" and 1,047 "contractual" joint ventures in China.² In addition there were 18 cooperative projects for exploration for and exploitation of offshore oil. We estimate that at yearend 1983, total paid-in foreign investment on these three forms of direct investment amounted to approximately \$1.5 billion. Of that total about \$380 million is located in the four Special Economic Zones, with the bulk in Shenzhen, on the Hong Kong border. If licensing agreements, processing and compensation trade, and wholly-owned foreign subsidiaries are included in the totals, in accord with Chinese practice (as shown in the tabulation below), total paid-in foreign investment amounted to \$2.3 billion through the end of December 1983.

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² From a Western viewpoint, both forms of joint ventures, as well as joint oil exploration agreements and wholly-owned foreign subsidiaries, are considered direct foreign investment. In our balance of payments estimates, other forms of business arrangements, such as licensing, processing, and compensation trade agreements, are not treated as foreign investment since no foreign claims on real assets located in China exists. The Chinese, however, use the term "foreign investment" loosely to refer to all forms of foreign participation, even including loans to Chinese enterprises. The Chinese appear to use the term "cooperative production agreement" synonymously with contractual joint venture. From a Chinese legal viewpoint there are three chief distinctions between contractual and equity joint ventures. Equity joint ventures:

(1) fall under the Joint Venture Tax law (a flat 33 percent tax), whereas contractual ventures are taxed on a graduated basis under the Foreign Enterprise Income Tax;

(2) share profits in proportion to equity participation, whereas contractual joint ventures share profits according to a ratio agreed to in the contract;

(3) form new legal entities with their own boards of directors, whereas contractual joint ventures are managed directly by their parent corporations.

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Chinese Data on Direct Foreign Investment

(Million US\$; yearend)

<u>Type</u>	<u>Pledged</u>			<u>Paid-in</u>	
	<u>1981</u>	<u>1982</u>	<u>1983</u>	<u>1982</u>	<u>1983</u>
Total	2,846	4,958	6,600	1,769	2,345
Equity Joint Ventures	88	141	340	103	166
Contractual Joint Ventures	1,800	2,726	2,900	503	730
Joint Oil Exploration	398	999	2,000	486	651
Compensation Trade	460	725	930	413	542
Other Businesses (a)	...	367	420	237	254

(a) Including wholly owned foreign enterprises and licensing agreements.

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US Investment in China

US firms have established nearly two dozen joint ventures, one wholly owned subsidiary, and countless cooperative arrangements (licenses, compensation trade, assembly or processing accords, buy-back deals) in China since 1979. According to the Ministry of Foreign Economic Relations and Trade, US investment in equity joint ventures was \$85-to-90 million at the end of 1983. In addition, US firms are involved extensively in China's search for offshore oil, with contracts costing US companies about \$300 million. Together with cooperative arrangements, we estimate that US investment in China now totals as much as \$500 million dollars. By contrast, Occidental's 1984 contract to develop coal mines at Ping-shuo will cost the participating US firms about \$350 million.

Foreign Debt and Finance

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As of June 1984, China had accumulated \$16.5 billion in foreign exchange reserves. In addition, the Chinese have used very little of the \$27 billion in commercial and government-supported credit lines they arranged in 1979 (see table 2). Fiscal conservatism and cutbacks in capital expenditures, rather than the previous ideological aversion to foreign debt, have left little need for these loans. Further, Beijing's economic development plans are based on the assumption that foreign--and

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especially US--firms perceive China as an untapped market with great growth potential; by enticing firms to assist Chinese enterprises in exchange for products, China hopes to modernize its industries at a minimum cost. [REDACTED]

China's current outstanding debt of \$5.7 billion is a mixture of commercial and official loans, with a wide range of maturities. For the past three years commercial borrowing has been cut back sharply and it now accounts for less than one-fourth of total debt. China is seeking only concessionary loans and will avoid incurring commercial debt for all but short-term trade financing. [REDACTED]

During 1983, Beijing and Tokyo concluded an agreement extending \$2 billion in Overseas Economic Cooperation Fund loans to cover seven major development projects in China. The loans can be drawn over the next five years, carry a 3.5 percent interest rate, and allow repayments over 20 years, following a 10-year grace period. Earlier this year Tokyo also agreed to extend another \$2.6 billion in Export-Import Bank resource development loans to cover oil and coal development projects. The new loans will carry interest rates of 7.1 to 7.3 percent. This compares with the 6.25-percent rate on a \$2 billion line-of-credit that Japan Ex-Im provided in 1979. [REDACTED]

The Chinese also obtained \$1.9 billion in commitments from the World Bank to cover 18 projects, energy, communications, agriculture, education, and medicine. Of the total, the IBRD has contributed \$1.2 billion and the IDA has contributed more than \$700 million. Only a small fraction of the loans have been drawn. While these loans might appear, at first glance, to "crowd out" commercial lending, this probably is not the case, since most of them are for infrastructural projects that do not provide high or immediate returns and thus would not be attractive to commercial lenders. [REDACTED]

We expect China to continue financing its development very conservatively. Beijing expects to begin using its reserves more heavily and will continue to rely on compensation trade mechanisms as much as possible to cheaply acquire advanced foreign technologies and equipment. When foreign financing is required, we expect Beijing to seek concessionary loans on the basis that China is a poor country and therefore deserves preferential treatment. [REDACTED]

Trade Trends

In the five years from 1979 to 1983, total Chinese two-way trade grew at an average annual rate of nearly 11 percent, while US-China trade averaged a robust 17.5 percent per year. Total Chinese exports have led trade expansion with an average annual growth of 15 percent. Expansion of sales to the US doubled that

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pace, however, primarily because of nearly 40 percent average annual growth in exports of textiles and apparel. The United States accounts for about 10 percent of China's total trade. []

The transition phase that the Chinese trade structure is undergoing makes estimates of China's trade for the rest of this decade difficult. The key factor that will affect trade is China's progress implementing the reforms recently introduced or currently under consideration. The decentralization of foreign trade, opening of domestic markets to joint venture products, and other changes could have significant positive impact on total trade if the reforms work as well as those implemented in agriculture over the past few years. China's leadership has proposed 7-to 8-percent annual growth for the domestic economy during the Seventh Five-Year Plan (1986-90) and plans to quadruple total trade by the end of the century imply about 8 percent average annual growth in trade. If average annual increases in actual merchandise trade fall within this 7-to-8 percent range, then the total would be about \$70-75 billion by 1990. At least half of that amount would be exports, primarily because:

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- China strongly wishes to avoid trade deficits;
- Strong export growth of recent years will moderate as international trade protectionism limits primary markets for China's largest export products.
- Beijing could reduce imports if necessary to maintain balanced trade.

We believe these totals are conservative estimates of trade growth, however, and that the actual levels of trade would rise further if reforms are successfully implemented. []

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Nonetheless, based on these projections and assuming the United States continues to account for 10 to 12 percent of China's total trade, then US-China trade by 1990 would reach \$7-9 billion. Because China is trying to reduce its dependence on OECD markets and because we expect export growth to moderate, we estimate that China's exports to the United States will remain at a level that averages 10 percent of total exports (about the same share as 1982-83); that would amount to \$4-4.5 billion by 1990. Similarly, with China seeking alternative suppliers, we expect the US share of total imports to fall far below the 20 percent level of 1981 and perhaps to approximate the 12 percent level of 1983, which would mean \$3.3-3.6 billion in Chinese imports from the US in 1990. []

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Outlook for China's Imports

China's interests in industrial advancement and export development will stimulate new import patterns. During the next few years we expect capital goods and software--designs,

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blueprints, training--to constitute a greater share of Chinese imports, while the share taken by agricultural products ebbs. Software fees are not itemized in trade statistics, but we estimate that expenditures for software exceeded \$2 billion last year. [REDACTED]

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China has more than 300,000 industrial enterprises that need at least some capital improvements and massive infrastructural development. More than \$16 billion in foreign exchange reserves and additional billions in untapped foreign loans have long suggested an imminent groundswell in capital imports. However, Beijing is wary of another massive surge in plant and equipment purchases like the 1978 binge that led to contract cancellations and embarrassment. Thus emphasis for the rest of this decade will be on projects to upgrade existing factories, especially with foreign investment and advice or under the auspices of Western assistance programs. China significantly stepped up imports of industrial supplies and capital goods in 1983 and we expect imports to further accelerate this year, perhaps by 25 to 30 percent, then to moderate in the last half of the decade. Import gains can be expected in such industrial materials as lumber, nonferrous metals, fertilizers, and plastics. Among capital goods, products for the transportation and energy sectors will lead import growth, particularly aircraft, trucks, locomotives, power plant equipment, oil drilling gear and mining equipment. China will also continue to seek out used plants and equipment such as the Kaiser Steel plant being relocated to Beijing from California. [REDACTED]

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Other categories with significant potential for US exports to China are high technology and weaponry. China prefers to acquire manufacturing capabilities in these sectors and is subject to export controls on certain technologies. Prospects of prolonged negotiations and approval processes dictate against substantial increments in the value of US-China merchandise trade from these sectors during the rest of the 1980s. [REDACTED]

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Favorable weather patterns have led to four consecutive years of bumper harvests, reducing the overall need for imports of agricultural commodities. Furthermore, the Chinese are reducing acreage sown to foodgrains in order to increase the output of such commercial crops as cotton, soybeans, and oilseeds. These adjustments are having a major impact on China's agricultural trade. Last year, for example, China cut back substantially on cotton imports and actually began exporting raw cotton for the first time. [REDACTED]

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Prospects for China's Exports

China's early forays into export expansion have focused on improving, packaging, and marketing traditional light industrial products. Early 1984 trade statistics suggest a growing export capability in such product groups as toys, collectibles (coins, antiques), housewares (wicker, china, plasticware), processed

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foods, and chemicals. The Chinese, especially through joint foreign-Chinese firms, are actively searching for additional marketing opportunities. [REDACTED]

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Certain agricultural products may offer export opportunities. If Chinese exporters can meet international quality and other standards, then within the next few years China could emerge as an important exporter of raw cotton, and could increasingly compete with US suppliers of cotton, soybeans, and corn to Japan and other major Far Eastern markets. However, we believe that, together with fluctuations in future weather-related growing conditions, the needs of China's growing population will work against large-volume exports of unprocessed agricultural products. [REDACTED]

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China's long term economic plans apparently include substantial growth in machinery and equipment exports as well. Beijing already exports such machinery as basic machine tools and small hydropower generators. Various ministries, corporations, factories, and provinces have developed at least tentative plans to upgrade their manufacturing facilities and to improve output quality in order to become competitive within the next five to 15 years in such diverse products as machine tools, chemicals, and process controls. China is pushing electronics development in particular, driving to double by 1990 the output of semiconductors, communications equipment, computers, and consumer electronics for both domestic use and export. [REDACTED]

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We believe the Chinese will not be able to absorb technologies fast enough for finished manufactures to become a significant share of exports within the next decade. China's ability to absorb technologies has been circumscribed by such factors as a shortage of skilled personnel, lack of incentives for plant officials and planners, and poor planning and prioritization. We believe that Chinese industries will progress technologically, but their average technical level will continue to lag that of the developed world. [REDACTED]

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It is likely, however, that China will substantially expand component assembly operations under the auspices of Western firms. Machine tool sales probably will increase, particularly those tools that are of relatively uncomplicated designs and require predominantly hand machining and assembly. Exports of such small manufactures as hand tools, spare parts, and industrial fasteners also are likely to show rapid growth. Some of these products could displace the sales of US firms, but no more so than similar exports already coming from Pakistan, Taiwan, South Korea, and others. [REDACTED]

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